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THE WHITE HOUSE WASHINGTON

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CABINET AFFAIRS STAFFING MEMORANDUM

Date: _	11/1/85	Number:				Jun C	wald
Subject:	Economic Pol				Preside	nt Monday	7,
	November 4,	2:00 P.M.	Cabin	et Room			•
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RETURN TO:

Alfred H. Kingon
Cabinet Secretary
456-2823
(Ground Floor, West Wing)

The agenda and background paper are attached.

☐ Don Clarey ☐ Rick Davis

☐ Ed Stucky

Associate Director

THE WHITE HOUSE

November 1, 1985

MEMORANDUM FOR THE ECONOMIC POLICY COUNCIL

FROM:

EUGENE J. MCALLISTER EM

SUBJECT:

Agenda and Paper for the November 4 Meeting

The agenda and paper for the November 4 meeting of the Economic Policy Council are attached. The meeting is scheduled for 2:00 p.m. in the Cabinet Room.

The single agenda item is the Farm Credit System (FCS). The Council will review the financial condition of the FCS and discuss the legislative actions necessary to strengthen the FCS.

ON FILE NSC RELEASE INSTRUCTIONS APPLY

Attachment

THE WHITE HOUSE

ECONOMIC POLICY COUNCIL

November 4, 1985
2:00 p.m.
Cabinet Room

AGENDA

1. Farm Credit System

THE WHITE HOUSE

WASHINGTON

November 1, 1985

MEMORANDUM FOR THE PRESIDENT

FROM:

THE ECONOMIC POLICY COUNCIL

SUBJECT:

Farm Credit System

The Economic Policy Council has been following the difficulties of the Farm Credit System (FCS) very closely. The Council and its Working Group on Agricultural Credit Policy have been meeting with representatives of the FCS and the Farm Credit Administration (FCA), the Federal body which loosely regulates the FCS, to determine the scope of the FCS's problems, its capacity to absorb losses, and the package of restructuring initiatives necessary to help the FCS solve its own problems.

The Economic Policy Council has reached two conclusions:

- The FCS is experiencing genuine financial difficulties and will report nearly \$6 billion in loan losses over the next three years.
- 2. The FCS, however, does appear to have sufficient earned surplus to absorb these losses without jeopardizing stock held by the borrowers (the farmers) if it is restructured to permit greater sharing of system-wide financial resources.

Earlier this week, the Council recommended to you several policies the Administration might pursue in testimony before Congress. You accepted those recommendations, and the Administration policy regarding the FCS and its difficulties is to:

- Restructure the FCA into a true regulator;
- Create authorities for the Farm Credit System Capital Corporation (FCSCC) to fully mobilize the FCS's earned surplus to absorb operating losses and to manage troubled loan assets; and
- 3. Assess the need for Federal financial assistance but only if Congress is willing to legislate the changes that will accomplish 1 and 2 above.

This memorandum is intended to convey to you in greater detail the Council's conclusions regarding the financial condition of the FCS and the specifics of the legislative changes that we seek for the FCA and the FCS.

SCOPE OF THE PROBLEM

- FCA and FCS estimates regarding the size of their potential problems due to bad assets and the potential losses to the System are not unreasonable. The exact size and timing of losses is, however, tied somewhat to the future course of the economy and the farm sector.
- o The System will have to report substantial overall losses over the course of the next three years, representing approximately \$3 billion for 1985 and \$1.5 billion in each of 1986 and 1987.

Capacity of the System to Handle the Problem

- o The System does appear to have sufficient earned surplus and earnings in spite of the bad assets to enable it to absorb those assets without jeopardizing stock held by borrowers.
- The System's assessment of its ability to absorb losses is far too conservative because they: (1) believe FCS needs low leverage to borrow (8:1), where in fact "agency" borrowers borrow effectively with much higher leverage (70:1); (2) only grudgingly tap the surplus of System banks (\$4.1 billion at year-end 1984) and resist tapping the surplus of System associations (\$2.1 billion at year-end 1984) (there also were loan loss reserves of \$1.3 billion); (3) believe competition will force them to compress the net interest margin considerably below 1985 levels, which are low by historical standards; and (4) fear the flight of good borrowers (with their borrower stock, which FCS is reluctant to tap anyway).
- o If bond market investors believe FCS has lost the "implied" backing of Government, FCS is correct to fear an adverse market reaction to its losses and erosion of capital. But if bond market investors receive sufficient assurance and permit FCS to roll over its debt, total FCS (banks and associations) surpluses and loss reserves should provide a sufficient cushion. Even if agricultural conditions worsen beyond FCS's projections, it should take another year or two to work through FCS's total surplus.
- o FCS fears about competition and borrower flight have some validity, but not enough to require Federal funds now. Many FCS competitors are also ailing. As an "agency" borrower, an efficient FCS should be able to compete. Furthermore, the number of FCS borrowers who can pay off their loans or find an alternative source of credit for land loans (about \$50 billion of FCS's portfolio) is probably limited in today's market environment.
- O The current surplus should also enable the System to continue operating as a <u>viable</u> lender, with the possibility of its returning to a break even or minimally profitable operation

in 1988. Using basically FCA and FCA's own estimates for 1985-87 and a simple extrapolation to 1988 produces the following selected financial statistics for the consolidation of the 37 banks and all local associations:

(\$ Millions)

	1984	1985	1986	1987	1988
Net Income	373	(2,800)	(1,348)	(1,412)	small but positive
Surplus	6,200	3,400	2,100	700	700+
Total Capital	11,800	8,700	7,000	5,100	5,100+
Loan Loss Reserves	1,300	3,300	3,000*	2,300*	*
Capital as a % of Assets	13.5%	10.6%	9.2%	7.8%	7.8%+

^{*} These numbers depend on the rate at which charge-offs are incurred to reflect foreclosures and restructurings. We used FCS's assumptions about holding non-earning assets, which do not envision an aggressive disposal process.

LEGISLATIVE PROGRAM

There appears to be substantial agreement between the Administration, the FCA, and FCS regarding improved use of the System's surplus and capital funds and broad major regulatory reforms.

Some areas of current potential disagreement remain, the most notable being the need for, and form of, Federal financial assistance. There are also details underlying major areas of agreement which must be resolved.

The broad principles for a legislative program recommended by the Economic Policy Council are as follows:

1. Managing Surplus and Capital Accounts

The best mechanism for handling the System's bad asset problem is to permit the Farm Credit System's Capital Corporation (FCSCC), established under the FCS, to:

- a) acquire from the System loans and property at no greater than market value;
- b) assume obligations for consolidated FCS debt so as to carry the assets while they are being held, leased, or restructured in an orderly fashion;

- c) extract earned surplus from those operating units which have it and transfer it to those which are in deficit;
- d) assess the operating units sufficiently to capture their future earnings as support for FCSCC's debt service obligations and operating losses, subject to existing FCA regulations to transfer capital.

2. Reforms in Regulatory Authorities

The best mechanism for ensuring a permanent solution to the System's operating problem is to provide a strong and effective regulatory agency with authority broadly similar to that regulating nonfarm financial institutions.

The reformed regulatory authority should be provided with general powers that include:

- a) restructuring of present management board with a single Chairman appointed by the President;
- b) general rulemaking authority and examination and enforcement powers;
- c) power over exit and entry to the system, including approval and/or requiring mergers;
- d) authority to establish capital requirements and safety and soundness provisions.

ASSESSING THE NEED FOR FEDERAL ASSISTANCE

The Department of Agriculture, in its testimony, has emphasized that the Administration will assess the need for Federal financial assistance, but only if Congress is willing to legislate the changes that will restructure the FCA and strengthen the FCS and the FCSCC.

James A. Baker III Chairman Pro Tempore